DOMINANT CARRIER REGULATION AND STRENGTHENED PERFORMANCE MEASURES WILL HELP PREVENT BOC ANTICOMPETITIVE BEHAVIOR

Dominant carrier regulation will require the BOCs to provide cost support and usage data so as to permit the Commission to assess a BOCs compliance with imputation, cost allocation, nondiscrimination and affiliate transaction requirements, and in so doing to forestall the BOCs' ability to leverage their local market power into the adjacent and presently competitive long distance market.

74 Evidence of BOC market power and market power abuses indicate that the competitive safeguards of the separate affiliate provisions of Section 272 currently being relied upon by the FCC have failed to prevent anticompetitive conduct If the purpose of enacting Section 272 was "in order to check potential market power abuses," then it is both necessary and entirely appropriate for the Commission, in this proceeding, to determine whether the BOCs still possess market power and, if they do, that one fact alone provides sufficient basis and justification for enforcing strong requirements designed to preclude *integrated* BOCs from further leveraging their control over bottleneck facilities to gain a competitive advantage over their interLATA competitors The presence of pervasive market power and market dominance by the BOCs in the residential and small business local services affords BOCs with:

- The unique ability to leverage that local market power so as to diminish competition in and, ultimately, to remonopolize the adjacent residential/small business long distance market,

- The ability and the incentives to discriminate against competing local and long distance carriers with respect to the provision of essential services; and

- The ability and the incentives to price those essential services and their own retail services in such a way as to create a price squeeze, the practical effect of which will be to make effective competition in the retail service market all but impossible

75 The BOCs' unique ability to engage in joint marketing and to benefit uniquely from their legacy relationships with the vast majority of residential and small business local service customers in their effort at acquiring long distance market share has the potential to lead ultimately to BOC remonopolization of the long distance market, at least at the retail residential and small business level That potential is exacerbated when the separate affiliate requirement is eliminated, because the BOCs are then in a position to complement their already substantial marketing advantage with the additional ability and opportunity to discriminate against competitors in the provision of access and other essential services and the creation of price squeezes between the BOCs' own retail long distance prices and those being charged to rivals for access to the BOCs' networks Remonopolization will ultimately lead to higher retail long distance prices, potentially costing consumers billions of dollars nationwide And we won't have to wait for full remonopolization before those rate increases will be initiated Whatever the "costs" of stringent regulation of the BOCs' integrated interLATA service provisioning practices, the potential harms to competition and consumers arising from BOC remonopolization of retail long distance services more than justify those "costs" on a strictly cost/benefit basis.

76 Importantly, when the separate affiliate requirement is allowed to sunset and the Section 272(b)(1) "operate independently" and 272(b)(5) "arm's length" requirements are eliminated, BOCs are no longer under any obligation to "sell" access services to their long distance business

units at tariff rates The sole remaining "safeguard" against discrimination with respect to access services will be Section 272(e)(3), which is not subject to the sunset provision Section 272(e)(3) requires the BOC to " impute to itself (if using the access for its provision of its own services), an amount for access to its telephone exchange service and exchange access that is no less than the amount charged to any unaffiliated interexchange carriers for such service " "Imputation" requirements of this type are applied by state commissions in the case of ILEC-provided competitive *intraLATA* toll services, but due to the absence of explicit access charges, precise application of such rules is particularly difficult ILECs have argued, for example, that they are free to aggregate different services together in demonstrating that the imputation requirement has been satisfied, which may permit certain services to be priced below the imputation level only to be offset (i e , cross-subsidized) by others whose prices exceed the applicable access charges Such contentions have been rejected by state commissions,[102] but only after the practice had been underway for some time and following often protracted litigation Proper application of an imputation requirement such as that contained at Section 272(e)(3) would require the BOC to demonstrate that its retail price exceeds the sum of the imputed access charges together with all costs incident to the value-added (long distance) services of which those access services are a component Short of protracted complaint proceedings, I am not

102 *See, e g Application of Qwest Corporation for an Increase in Revenues,* Oregon Public Utilities Commission, Order no 01-810, 2001 Ore. PUC LEXIS 449, September 14, 2001, (order unpaginated, at "Access Charge Imputation" section), and *Application of US West Communications, Inc , for the Commission to Open an Investigatory Docket to Eliminate on an Expedited Basis the Requirements that US West Impute Switched Access Rates into the Price Floor of its IntraLATA Long Distance Service,* Colorado Public Utilities Commission, Docket No 00A-201T, 2001 Colo PUC LEXIS 133, January 24, 2001, at *16

aware of any remaining mechanism, especially for an integrated local and long distance BOC, that would permit the Commission or affected competitors to verify compliance with Section 272(e)(3).

77. Regulation of BOC long distance affiliates and integrated long distance business units as dominant carriers will provide the Commission with a mechanism to enforce the Section 272(e)(3) imputation requirement. BOCs will be required to submit additional supporting information with tariff transmittals that are sufficient to demonstrate that their rates fully recover all relevant *non-access* incremental costs and also satisfy access imputation. Specifically, dominant carriers with gross annual revenues exceeding $500,000 for the most recent 12 month period must submit an explanation of the changed or new services and/or rates, the "basis of ratemaking employed, and economic information to support the changed or new matter."[103] This economic information includes a cost of service study for all elements for the most recent 12 month period, a study containing a projection of costs for "a representative 12 month period", and estimates of the effect of the tariff change upon the traffic and revenues from that service (or the effect of the new tariff), the carrier's other services and the carrier's "overall traffic and revenues."[104] Dominant carriers must also provide the Pricing Policy Division of the Commission with working papers and statistical data supporting the tariff change or filing of new service.[105]

103. 47 CRF §61.38 (b).

104. 47 CFR §61.38 (b)(1).

105. 47 CFR §61.38 (C).

78. The supporting cost data required by dominant carrier regulation is the only viable means for the Commission to verify compliance with the imputation requirements of the Act. As previously noted, the BOCs already offer interLATA pricing plans that likely violate the imputation requirements of Section 272(e). A projection of costs including imputed access and actual non-access costs would enable the Commission to determine whether plans such as the $15 Verizon unlimited interLATA offering create a price squeeze.

Current imputation rules are ineffective in protecting competing IXCs from price squeezes and other anticompetitive conduct on the part of BOCs.

79. In addition to ignoring the Commission's "softer" requirements regarding affiliate transactions, the BOCs are flouting the Section 272(e)(3) requirement that a BOC "shall charge the affiliate described in subsection (a), or impute to itself (if using the access for its provision of its own services), an amount for access to its telephone exchange service and exchange access that is no less than the amount charged to any unaffiliated interexchange carriers for such service."

80. As I have previously discussed, BOCs continue to maintain overwhelming dominance of the local exchange telephone service market, particularly in the residential and small business segment. In order to provide long distance services to most residential and business customers, IXCs *must* purchase switched access services from a BOC or other ILEC. For this reason, intrastate switched access must still be considered and treated for regulatory purposes as a monopoly bottleneck essential service.

81 Because the BOCs continue to serve the vast majority of subscriber lines, in order for an IXC to reach most consumers and businesses for purposes of both originating and terminating toll calls, it must pass through an ILEC "gateway" and pay the ILEC access charges at whatever rate applies Now that ILECs (especially BOCs) are themselves heavily involved in the long distance business, they have a strong business incentive to keep their intrastate access charges as high as possible so as both to increase rivals' costs and to maintain artificially high retail long distance prices while still setting those prices at or even below the level of the *wholesale* access charges that rival IXCs are forced to pay

82 In theory, the "imputation" requirement at Section 272(e)(3) is supposed to address and resolve this concern. Imputation is supposed to impose "pricing parity" as between the BOC and its rivals - whatever the BOC charges its competitors, it is supposed to charge — or "impute" — to itself However, BOCs do not actually pay *themselves* cash out-of-pocket for whatever access services (or their equivalent) they utilize in furnishing long distance services Such payments by the long distance affiliate -- particularly where the BOC entity is subject to "pure" price cap regulation without any earnings sharing or earnings cap requirement — are intra-corporate "paper" transactions that have no effect whatsoever upon the parent corporation's "bottom line" The BOC will never incur any *originating* access charges and, since the vast majority of BOC-originated intrastate toll calls are also terminated to customers of the same BOC, the BOC will be required to make a cash payment for terminating access to a different

LEC for only a very small fraction of all intrastate calls originated by its local service subscribers.[106]

83. The purpose of requiring that a BOC "impute" access charges into the retail prices it sets for its end-user services is to try to force the BOC to treat as "costs" to itself the level of payments that its competitors are required to make to the BOC for access services. Unfortunately, however, since BOCs do not actually incur such "costs" in the form of out-of-pocket cash payments to another entity, the imputation requirement does not interfere with their overall

106. In its 1997 *LEC Classification Order*, the Commission (at para. 129 and based upon a claim made by Ameritech) theorized that "a BOC interLATA affiliate's apparent cost advantage resulting from its avoidance of access charges may be offset by other costs it must incur, such as the cost of interLATA transport, which, at least initially, may be greater than the true marginal cost of interLATA transport for facilities-based interLATA carriers." Not only is there no evidence to affirmatively support this claim, it is likely to be wrong as a matter of fact. Under the so-called "official services exception" of the *MFJ* (United States v. Western Electric Co., 569 F. Supp. 1057, 1097 *et seq.*), the BOCs were expressly permitted to construct, maintain and utilize interLATA facilities for the purpose of transmitting intracompany (so-called "official") traffic. Over time, the BOCs were authorized to expand the use of these intracompany networks to include, for example, the transmission of calls to directory assistance and operator services to remotely located centralized facilities. The succession of RBOC mergers expanded the geographic scope of these networks to correspond with the now more expansive RBOC operating regions. The costs of these interLATA fiber-optic transmission networks were absorbed by the regulated BOC entities, and much of those capital outlays have by now been recovered in depreciation accruals included in rates for monopoly services charged to BOC ratepayers. If the Section 272 separate affiliate requirement is ultimately permitted to sunset for all BOC Section 271 jurisdictions, these facilities will be available to the BOCs for use in providing long distance service at little or no incremental cost. Thus, rather than somehow "offsetting" the BOCs' access cost advantage, the existence of these extensive interLATA networks affords them a formidable interexchange transport cost advantage as well.

profit incentives, which are to maximize profits relative to actual costs, not artificially contrived "costs" that do not really exist.

84 In fact, an examination of BOC and long distance affiliate conduct demonstrates that any such "imputations" are being ignored altogether when it comes to setting retail long distance prices. Verizon's unlimited long distance calling plan, *Veriations Freedom*^{SM}, consists of two separate service components, one of which is furnished by the Verizon BOC entity and the other by VLD I have previously addressed the serious imputation issues surrounding the VLD inter-LATA plan arising from its aggregation of interstate and intrastate services The *local* component is usually called "Local Package Basic" or "Local Package Plus" (or a similar name) Filed with the state commissions in the appropriate local tariff, the Local Package Basic and Local Package Plus plans offer basic local exchange dial tone service with unlimited local calling, a selection of vertical "custom calling" features (usually three or four features for Local Package Basic and either a larger number of features, or all features that are available, for Local Package Plus), voice mail, and unlimited intraLATA toll calling (and sometimes unlimited directory assistance calling) All normal nonrecurring charges are typically waived. Prices for these plans typically range from approximately $35 to $55 [107]

85 When intrastate toll services are combined with services other than intrastate toll and priced on a bundled basis, as is the case with the Veriations Freedom^{SM} package, the precise

107 *See*, para 40 *supra*

identification of the "pure" price for the intrastate toll component requires further analysis. A number of the Verizon BOCs have for some time been offering their subscribers a choice of two service bundles that they call something like "Local Package Standard" and "Local Package " These packages include a selection of custom calling features but do not include unlimited intra-LATA calling Verizon Virginia, for example, offers its Local Package Plus bundle at $32.95 per month, not including Voice Mail, which is offered for an additional $6.50 per month, for a total of $39 45 The Local Package Plus includes a local exchange dial tone line, unlimited local calling, all available custom calling features and unlimited local directory assistance, but does not include the unlimited intraLATA toll feature By comparison, the monthly rate for the Veriations Freedom℠ Local Package Plus bundle, which includes all of the same features *plus* unlimited intraLATA toll, is $39 95 On that basis, we can identify the effective price for the unlimited intraLATA toll calling feature as the difference between these two prices, i.e., $0.50. This analysis is summarized on the following table, which compares the currently available bundled "Local Package" with the similar Veriations Freedom℠ "Local Package Plus" bundles

Table 2

Verizon Virginia
Analysis of Effective Monthly Price for Unlimited IntraLATA Toll Calling

Rate element	**Local Package**	**Local Package Plus (Veriations Freedom℠)**
Monthly rate	$32.95	$39.95
Basic local dial tone line	Included	Included
Unlimited local calling	Included	Included
Vertical features	All	All
Unlimited local directory assistance	Included	Included
Voice mail	$6.50	Included
Unlimited intraLATA toll calling	Not included	Included
TOTAL PRICE	$39.45	$39.95
Effective price of unlimited intraLATA calling		**$0.50**

Verizon Virginia Inc. General Services Tariff S C.C. Va. No. 203, Section 31, 2nd revised page 2-3, effective November 4, 2002; Original page 4-5, effective November 4, 2002; Original page 6-7, effective February 3, 2003.

86 As I have previously noted, Verizon promotional materials put the average "regional toll" (i.e , intraLATA) usage of its Veriations Freedom℠ bundle at 300 minutes per month. Assuming an average intrastate switched access rate (originating + terminating) of 7 5 cents per minute, Verizon would need to "impute" some $22.50 worth of access charges into a service that it offers at retail for just 50 cents! By any standard, Verizon is not coming even remotely close to satisfying any "imputation" requirement with respect to the pricing of this service. Verizon would clearly not offer a service at a price of 50 cents if its actual "cost" were at least $22.50,

the fact that Verizon is doing so despite the access imputation requirement demonstrates that Verizon affords no importance to that imputation requirement in dictating or constraining its pricing conduct. Unfortunately, any competing non-affiliated interexchange carrier offering a comparable flat-rated service and anticipating similar usage characteristics would be required to pay that $22.50 *in cash* to Verizon and other LECs for access services, and so would have no practical means for competing with Verizon's 50 cent retail price.

87. The matter of access imputation is expressly addressed in the 1996 *Act*. As a threshold matter, Section 272(e)(3) requires that

> [a] Bell operating company and an affiliate that is subject to the requirements of section 251(c)) . shall charge the affiliate described in subsection (a), or impute to itself (if using the access for its provision of its own services), an amount for access to its telephone exchange service and exchange access that is no less than the amount charged to any unaffiliated interexchange carriers for such service.

Although the statute speaks of "imputation" of the BOC's own access charges, it does not specifically require that the price charged at retail for the BOC's or for its affiliate's long distance service actually be set in excess of the imputed access charge. Indeed, Verizon has recently argued that VLD is not subject to *any* imputation requirement with respect to its retail long distance rates.[108] Even if the BOCs were in fact treating "imputed" access charges as

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108. See *AT&T Communications of the Pacific Northwest, Inc., Complainant, vs. Verizon Northwest, Inc., Respondent*, Washington UTC Docket No. UT-020406, Verizon's Motion to Dismiss, April 24, 2002, at 11; Direct Testimony of Orville D. Fulp on behalf of Verizon Northwest, Inc., December 3, 2002, at 10-11.

"costs" when setting their own retail prices, which they obviously are not, the imputation requirement set out at Section 272(e)(3) is not by itself sufficient to prevent the BOC from creating a price squeeze situations for rival IXCs

88. Access charges are hardly the only "costs" than the BOC or a nonaffiliated IXC would incur in furnishing long distance services to retail customers Although the precise components of such "non-access" costs have been subject to some dispute,[109] there can be *no dispute whatsoever* that the non-access costs are greater than zero. If Section 272(e)(3) is interpreted as requiring only that the BOC and its Section 272 affiliate set their retail long distance prices *at no less than the "imputed" access charge payments*, the presence of *any* non-access costs would place rival IXCs in a price squeeze if the BOC's retail price fails to cover such non-access costs. From the BOC's perspective, non-access costs include, *inter alia*, sales and marketing, billing and collection, uncollectibles, customer care, and non-access network costs If the BOC's affiliate is providing retail long distance service by reselling wholesale long distance services acquired from another IXC - - as most of the BOCs are actually doing most of the time — then the wholesale rates being paid for the resold services would also constitute non-access costs. Many of the non-access costs associated with BOC long distance services involve services that are furnished by the BOC to its long distance affiliate (or post-sunset of Section 272, to its long distance business unit) on a fully integrated basis Thus, in addition to assuring that the BOC's

109 See generally *AT&T Communications of the Pacific Northwest, Inc , Complainant, vs. Verizon Northwest, Inc., Respondent*, Washington UTC Docket No UT-020406, Direct Testimony of Terry R Dye on behalf of Verizon Northwest and Direct Testimony of Carl R. Danner on behalf of Verizon Northwest, Inc , December 3, 2002

long distance prices recover both its imputed access charges *and* all applicable non-access costs, it is also essential that the manner in which the joint costs of functions supporting both the BOC's local and long distance services are allocated as between these two service categories be part of the tariff review process If the BOC assigns only the incremental portion of the joint cost of local/long distance functions (e g , sales and marketing, customer service, billing and collection) to the latter category, then it will in effect be conferring 100% of the benefits of integrated operation upon its competitive long distance business And, for any IXC that attempts to provide long distance service without also providing the customer's local service as well, the BOC's actions will necessarily work to create a price squeeze to the extent that the IXC is required to provide these same support functions on a stand-alone basis.

89 BOCs have also argued that any imputation test should be made in the aggregate, with respect to all categories of interexchange services, not on a service-by-service basis.[110] Under that theory, a particular service could fail imputation so long as another service passed the "imputation test" by an amount sufficient that, taken together, the two in aggregate satisfied the imputation requirement. Thus, the BOC could use profits from intraLATA toll, for example, to cross-subsidize interLATA toll, so long as the two services taken together nominally satisfy imputation Along the same lines, a BOC could offer a flat-rated toll service[111] that by itself does

110 *See, Section 272(f)(1) Sunset of the Separate Affiliate and Related Requirements*, WC Docket No. 02-112, Selwyn Declaration on Behalf of AT&T, filed August 5, 2002, ("*Selwyn Sunset Declaration*") at fn 83

111 Verizon New England offers its Massachusetts residential customers a flat-rated
(continued .)

not satisfy the imputation requirement, so long as profits from other by-the-call services provide sufficient contribution above access charges so that these two service categories, in aggregate, satisfy imputation [112] Since imputed access charge "payments" do not actually "cost" the BOC anything above the incremental costs of the access services themselves, imputation rules *per se* are not sufficient to prevent a BOC from engaging in price squeeze tactics.

90 If BOCs are permitted to provide interLATA and local services on a fully integrated basis, they will not use "access services" at all, and will gain enormous competitive advantage over competing interLATA service providers BOCs might then argue that any imputation requirement should be applied across all interexchange services (intraLATA and interLATA) in aggregate, creating the potential for inter-service cross-subsidization where the extent of actual competition differs from market to market Additionally, the elimination of the separate affiliate

111 (continued)
LATA-wide unlimited calling plan as well as optional extended calling plans to provide flat-rate calling to points that would otherwise be subject to toll charges, Verizon New Jersey offers "Selective Calling Service" whereby residential customers can obtain 20 hours of calling to specified ("selected") exchanges for a flat monthly charge

112 Verizon New Jersey (then Bell Atlantic New Jersey) had advanced just such an argument in response to a Complaint filed by AT&T in 1997, in which AT&T had argued that Bell Atlantic's "Selective Calling Service" did not satisfy the NJBPU's imputation requirement Selective calling provides block-of-time calling to specific nearby exchanges designated by the customer, for a small monthly charge Bell Atlantic's position was that as long as all of its intra-LATA toll in aggregate satisfied imputation, there was no requirement that Selective Calling Service by itself be priced in excess of applicable access charges. New Jersey Board of Public Utilities, *In the Matter of Petition of AT&T Communications of New Jersey, Inc for Determination of Compliance By Bell Atlantic–New Jersey, Inc.'s Selective Calling and Intramunicipal Calling Services with Imputation Requirements*, BPU Docket No. TO97100808, OAL Docket No PUCOT 11326-97N, Complaint of AT&T and MCI, filed October 1997.

requirement will make it all but impossible to actually track the costs that are being "assigned" to such competitive services, costs that are supposed to be added to the "imputed" access charges to determine whether the imputation requirement has been met

91 The BOCs' core position here is that they should be permitted to operate their *competitive* businesses (interLATA toll) *incrementally* with respect to their core monopoly local service business Under this theory, the captive local service customer pays the entire cost of all jointly-used network facilities and organizational resources. We have already seen examples of this philosophy with respect to the attribution of "joint marketing" costs to the 272 affiliate, with only the small increment of time that the service representative spends dealing with long distance service being "charged" to the affiliate [113] As long as the BOCs maintain near-total monopoly in the local market, competition under such conditions cannot be expected to survive for very long

92 A nonaffiliated IXC that is required to pay the BOC cash for any access services it utilizes in the provision of the IXC's retail long distance service cannot realistically afford to sell specific services at less than the sum of its access payments in connection with that service and its other, non-access costs of providing it A service-by-service imputation requirement puts the

113. Verizon New York charges Verizon Long Distance $7.71 per customer contact, while SBC Telecom charges SBCLD $17 95 in Texas per customer acquisition *See*, http://www.verizonld com/PDFs/jmaam40ratesch061603.pdf, http.//www.sbc.com/public_affairs/regulatory_documents/affiliate_agreements/SWBTtoSBCLDConsumerSupportSchedule994PA5-22-03 xls (accessed June 30, 2003)

BOC in essentially the same economic condition as its nonaffiliated rivals The BOC must be made to demonstrate, for each identifiable service offering,[114] that the revenues being derived therefrom exceed the access charges it would have had to pay were it a separate, nonaffiliated entity *plus* the non-access costs it incurs in providing the service. Additionally, notwithstanding the bundling of multiple services (such as local dial tone, vertical features, and long distance) into a single, unified pricing plan, the effective incremental charge for any individual component in the bundle (i e , the difference between the price of the bundle with the component and the price of the bundle without it) must similarly exceed the sum of imputed access charge (or other underling services being furnished by the BOC) plus the incremental non-access costs.

93 Implementation and enforcement of this requirement can only be assured under full dominant carrier regulation, because it is only through the tariff filing and review process that the relationship between rates and costs, and the manner in which the costs have been determined, can be evaluated. BOCs — Verizon and SBC in particular — are both seeking waivers of the Section 272(b)(1) "operate independently" requirement on the grounds that integrated operation of their local and long distance businesses will produce substantial cost savings due to the numerous cost synergies the BOCs allege to exist as between their local and long distance operations But the presence of substantial joint costs raises the specter of serious misallocation

114 "Service" in this context refers to a defined pricing arrangement that is being offered to retail customers There can be some flexibility with respect to individual pricing elements (e g., time-of-day discounts or "free" off-peak minutes), provided that in aggregate all of the individual element rates, multiplied by the quantities being demanded by all customers selecting the particular pricing plan, are sufficient to cover imputed access and incremental non-access costs

of those costs, favoring the competitive services to the detriment of the core monopoly services operations Without dominant carrier regulation and full tariff and cost reviews, there is little practical means even to identify, let alone correct, efforts by the then-integrated BOCs to assign as much of these joint costs to their regulated operations as possible, or to shift joint costs out of competitive services and over to monopoly services so as to support discriminatory pricing of their competitive services.

BOCs have both the means and the incentive to engage in predation, and will have the ability to raise prices once their rivals are forced out of the market.

94 In its 1997 *LEC Classification Order*, the Commission speculated that

> even if a BOC were able to allocate improperly the costs of its affiliate's inter-LATA services, we conclude that it is unlikely that a BOC interLATA affiliate could engage successfully in predation At least four interexchange carriers — AT&T, MCI, Sprint, and LDDS WorldCom -- have nationwide, or near-nationwide, network facilities that cover every BOC region These are large well-established companies with millions of customers throughout the nation It is unlikely, therefore, that a BOC interLATA affiliate, whose customers are likely to be concentrated in the BOC's local service region, could drive one or more of these national companies from the market Even if it could do so, it is doubtful that the BOC interLATA affiliate would later be able to raise prices in order to recoup lost revenues As Professor Spulber has observed, "even in the unlikely event that [a BOC interLATA affiliate] could drive one of the three large inter-exchange carriers into bankruptcy, the fiber-optic transmission capacity of that carrier would remain intact, ready for another firm to buy the capacity at distress sale and immediately undercut the [affiliate's] noncompetitive prices "[115]

115 *LEC Classification Order*, at para 107, footnotes omitted

Events since the 1997 release of this *Order* require that these assessments be reexamined The four IXCs specifically identified by the FCC have since become three, one of which is currently in bankruptcy BOCs have had unprecedented success in rapidly acquiring long distance market share — particularly in the residential/small business sector As I previously noted, SBC has reported a 60% share of the Connecticut long distance market after approximately five years since SNET began actively marketing interLATA services, and has advised investors that a similar end-state share can be expected for each of SBC's other Section 271 jurisdictions.[116]

95 Finally, the speculation advanced by Professor Spulber, which the Commission had at that time accepted, is also belied by subsequent developments While it is true that there is substantial interexchange network, the interexchange transport component of end-to-end long distance service is at this point a relatively minor cost element and its subsequent reacquisition and reuse by another carrier (following the bankruptcy of one or more of the existing entities) is neither assured nor particularly germane to the future of a competitive marketplace. The primary cost elements of retail long distance service consist of access charge payments to ILECs, billing and collection, advertising and marketing, and customer service, all of which dwarf the minuscule costs associated with interexchange transport. Even if a start-up long distance carrier were to obtain an in-place interexchange network essentially for free, its savings on network-related transport costs would be far less than the savings that a BOC is able to realize from not having to pay itself originating access charges and the various other integration efficiencies that

116 SBC Investor Briefing analyst conference call, January 28, 2003.

are available only to the BOC Indeed, because interexchange transport capacity is not a factor in limiting the supply of retail long distance service, it is extremely unlikely that any such capacity that might be released by a departing carrier would remain in use.

96 BOC bundled local/long distance pricing plans in which the price of the long distance component does not cover the sum of imputed access charges plus incremental non-access costs, together with the excessive access charge price levels that BOCs and other ILECs are permitted to apply, results in a price squeeze that has the potential to force stand-alone IXCs out of the market Were that to occur, the departing carriers' existing service infrastructures — sales and marketing forces, customer service personnel, operations support systems, billing system — the capacity that they require in order to compete with the BOCs' bundled offerings — will be disbanded and dismembered, reducing the number of active market participants and facilitating the BOCs' ability to increase prices following the departure of one or more stand-alone rivals The BOCs have both the means and the incentive to engage in predation, and will have the ability to raise prices once their rivals are forced out of the market Moreover, as I have discussed previously and notwithstanding the existence of price cap regulation, the BOCs are able to engage in predatory conduct via cross-subsidization of their below-cost long distance prices from high-margin local services Even if their predatory conduct is ultimately unsuccessful, they incur no losses from having pursued a price squeeze strategy And if successful, that strategy will support higher prices and higher profits in the future.

Price cap regulation is not by itself sufficient as a means for identifying or for preventing a BOC from using excess profits generated from monopoly local services to cross-subsidize competitive long distance services.

97 BOCs have frequently sought to dismiss claims that they are engaging in predatory pricing when offering retail long distance services at prices below their own wholesale access charge levels by professing an inability to engage in cross-subsidization when operating under "pure" price cap regulation In its 1997 *LEC Classifications Order*, the Commission similarly concluded that under price cap regulation the BOCs would have neither the ability nor the incentive to engage in cross-subsidization of competitive services by raising the prices of monopoly services.[117] Under this theory, "pure" price cap regulation supposedly limits the BOCs' ability to increase prices for monopoly services, thus removing the "engine" that would be needed in order to engage in a cross-subsidization strategy.

98 *Price caps remove regulatory oversight and therefore facilitate cost shifting through methods such as improper affiliate transactions* A recent regulatory audit of SBC-Pacific Bell undertaken by the California Public Utilities Commission[118] provides further demonstration of the utter ineffectiveness of price cap regulation — which has been in effect for Pacific Bell in California since January 1, 1990 — in preventing the transfer of monopoly revenues out of the operating company for the benefit of its nonregulated affiliates, *despite the nominal "de-linking"*

117 *LEC Classification Order*, at paras 126-128 12 FCC Rcd 15756, 15829 (1997).

118 California PUC, *Regulatory Audit of Pacific Bell For The Years 1997, 1998, and 1999*, Overland Consulting, issued Feb 21, 2002 and supplemented May 8, 2002 and June 20, 2002.

of revenues and costs The Audit Report found, among other things, that SBC-Pacific Bell and its affiliates had engaged in improper cross-subsidization, allowing SBC-Pacific Bell to substantially understate its operating income by, for example, transferring SBC-Pacific Bell CPNI for use by affiliates without reimbursement to SBC-Pacific Bell, and by paying the parent company SBC $400-million annually for SBC-Pacific Bell's use of the SBC brand name in California despite the transactions providing no apparent benefits to SBC-Pacific Bell. The California *New Regulatory Frameworks* ("NRF") price cap plan is subject to periodic (typically triennial) reviews by the California PUC Hence, the creation of such bogus "costs" and uncompensated transfers of value to an affiliate works to understate both realized productivity *and* realized earnings These (apparent) outcomes can then be advanced by SBC to support sought-after modification to the price adjustment mechanism, such as reduction or elimination of the productivity target (X-factor), elimination of any earnings sharing requirement, or other changes beneficial to SBC If successful, SBC will have been able to shift costs attributable to its competitive long distance business over to its monopoly local exchange service customers Thus, while there may be many desirable features of price cap regulation relative to traditional rate of return regulation, the foreclosing of cross-subsidization of competitive services is certainly not one of them Indeed, the experience in California and elsewhere suggests that, to the extent that cost and earnings reporting may be reduced as part of the shift to incentive-based regulation, the net effect of price cap regulation may well be actually to *facilitate* cross-subsidization of the BOC's (and its affiliates') competitive services by making such tactics far more difficult to detect

99. *Price cap plans often allow upward price movements on individual services, either as a result of reclassification or "baskets" of services* The BOCs' creation of local/long distance service bundles easily overcomes any price cap limitation, if indeed it is actually present at all Under price caps, only the overall *rate level* is capped; ILECs are afforded considerable flexibility with respect to the pricing of *individual* services within so-called "service baskets" Many state price cap plans permit the ILEC to "reclassify" services as "competitive" upon a demonstration of the presence of some limited number of alternative providers In seeking such reclassifications, the BOCs are generally not required to affirmatively demonstrate that the level of competition that they claim to exist is sufficient to limit their ability to increase prices, i.e., to constrain their exercise of market power Indeed, upon such reclassifications of putatively "competitive" services, BOCs are afforded pricing flexibility in both the *upward* as well as in the downward direction, and have indeed taken advantage of that *upward* pricing flexibility to increase rates on services reclassified as "competitive" in some cases almost immediately after the reclassification has been granted [119]

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119 Telecommunications Division, Illinois Commerce Commission, *Staff Report on Competitive Reclassification*, issued November 25, 1998 The ICC Staff found (at 5) that "[b]etween March of 1997 and November of 1998, Ameritech Illinois filed twelve tariff filings in which it reclassified several of its business and residential services as competitive." These were all in the form of tariff filings made on one day''s notice, and were permitted to go into effect. As the Staff Report notes (at 10), "[a]fter declaring some of the services listed above as competitive, Ameritech increased the retail and wholesale rates for those services." In some cases, *the prices of services that were already set well in excess of cost*, such as local usage, were increased

100 Such practices are not confined to the state jurisdictions BOCs have increased rates for *interstate* special access services in markets for which they have qualified for pricing flexibility, to the point where special access rates applicable in so-called "competitive" MSAs are in many instances *higher* than the corresponding rates in noncompetitive MSAs where the special access rates remain subject to price caps [120] The "baskets" of services method of price cap regulation allows the BOC to use the excess profits from special access services to subsidize truly competitive services in the same basket

101 Because BOCs often retain considerable market power with respect to "reclassified" services, they can increase rates for those services price caps notwithstanding, and use the excess profits derived therefrom to cross-subsidize services for which effective competition is actually present The local/long distance "bundles" are undoubtedly quite profitable as a whole, even though the incremental price for the long distance calling feature is less than the applicable access charges This is the case because the various vertical service features that are included in the bundle (call waiting, three-way calling, call block, caller ID) are so enormously profitable that their inclusion in the "bundle" is more than sufficient to offset the loss arising from the below-cost pricing of long distance. And, because these services are inextricably linked to the local exchange service platform, they cannot be offered by an IXC that does not also provide local dial tone to its long distance customer Such stand-alone IXCs — and services offered by

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120 Petition for Rulemaking to Reform Regulation of Incumbent Local Exchange Carrier Rates for Interstate Special Access Services, RM No. 10593, Declaration of Joseph M Stith on Behalf of AT&T, October 15, 2002

IXCs that are not bundled with the subscriber's dial tone line — are thus vulnerable to the precise type of cross-subsidization that is inherent in the BOCs' local/long distance bundles.

102 These limitations of price cap regulation go directly to the core of the issue being addressed in this FNPRM As *non-dominant* carriers, BOC long distance affiliates are not required to provide any cost support for their tariffs or (non-tariffed) prices Although the BOC Section 272 affiliates (and the BOCs themselves following "sunset" of the separate affiliate requirement) are supposedly subject to the Section 272(e)(3) access charge imputation requirement, without any obligation to provide cost support for their prices there is no formal mechanism by which the Commission can assess whether or not the BOC is in compliance with Section 272(e)(3) Counsel advises me that, as non-dominant carriers, BOCs and their Section 272 affiliates are not required to *prove* that their prices comply with the statutory prohibitions against cross-subsidization and that they satisfy the statutory imputation requirements, the burden of proof that they do not is borne by an aggrieved party, whose sole recourse is to initiate a formal Complaint with the Commission If history is any indication, it could take anywhere between 12 and 24 months for such a Complaint to be litigated and resolved, and even if the BOC's practices and prices are ultimately found to be unlawful, the BOC will have enjoyed the benefits of those unlawful prices for as long as the Complaint remains unresolved. Inasmuch as BOCs have been successful in adding 20 to 30 percentage points to their long distance market shares in states in which they offer in-region interLATA services during comparable 12-24 month periods, the potential losses to competitors would be irreparable.

103 Indeed, this may well provide a convenient basis upon which to evaluate the efficacy of treating the BOCs as dominant long distance carriers. Truly *non-dominant* long distance carriers have neither the economic wherewithall to engage in protracted below-cost pricing, nor the market power to materially impact competitors even if they did. BOCs, in contrast, possess both of these attributes. Absent the kind of *affirmative* regulatory oversight that is only possible where the BOCs are treated as dominant carriers, they will be able to crush their non-integrated rivals and ultimately remonopolize the national long distance market.

The Commission must adopt strong performance measures, enforced through an audit procedure, to ensure nondiscriminatory provisioning of special access services and facilities.

104 In addition to stringent imputation safeguards, the Commission must adopt strong performance measures and standards, supported by meaningful sanctions for discriminatory performance, to address the deficiencies in the BOCs' provisioning and support of special access services, such as those identified in both the New York and the Texas Audits.[121] The Commission should adopt the Joint Competitive Industry Group ("JCIG") Proposal under consideration in the *Performance Measurements and Standards for Interstate Special Access Services* proceeding, as well as implement a separate audit procedure for performance reports, to replace the Section 272 Audit review of these results.[122]

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121 See para. 61-70, *supra*.

122 *Performance Measurements and Standards for Interstate Special Access Services*, CC Docket No. 01-321, Comments of AT&T Corp., filed Jan. 22, 2002, at 23-29.

PREREQUISITES FOR BOC NON-DOMINANT CLASSIFICATION

Any public policy rationale for above-cost pricing of switched access services that may have been valid in the past no longer exists and cannot be squared with the goals of assuring and maintaining a competitive long distance market.

105 The policy of above-cost pricing of switched access service was driven by public policy considerations following the break-up of the former Bell System in 1984 as a means for maintaining the pre-divestiture practice of using toll revenues to subsidize basic residential service Previously, long distance toll rates were set well in excess of cost, with the bulk of total long distance revenues flowing to the local Bell companies via the intracompany "Division of Revenues Process" ("DRP") and to other ILECs via the settlements process. These arrangements were replaced by explicit, tariffed access charges in both the state and interstate jurisdictions IXCs would pay access charges to the BOCs and other ILECs, and would recover these access charge payments in their retail long distance rates As the long distance market became increasingly competitive following the break-up of the former Bell System, operating margins (between the retail price and the access charge payments) were commensurately narrowed, to the point where the principal cost component of retail long distance prices today is the above-cost access charge payments that the IXCs are forced to make to the BOCs and other local exchange carriers

106 At the time access charges first went into effect in 1984, the BOCs were precluded from competing with the IXCs in the interLATA market and, in most instances, the IXCs were

not permitted to compete with the BOCs for intraLATA traffic BOCs and many other ILECs were excluded from the interLATA long distance market either by the MFJ[123] or by the GTE/ Sprint Consent Decree.[124] IXCs initially did not even compete with BOCs in the *intraLATA* toll market In fact, AT&T and the other IXCs did not even receive authority to offer intraLATA services in many states until the mid-1990s [125]

107 As such, the policy of setting access charges well in excess of cost did not provide the BOCs with a competitive advantage vis-a-vis IXCs nor competitively disadvantage IXCs vis-a-vis BOCs However, access charges did operate to generally suppress demand for long distance services by forcing IXCs to set higher long distance prices than would have occurred had access charges been set at cost, thereby depressing IXC revenues and profits and denying consumers the benefits of lower long distance rates

108 At the interstate level, switched access charges have been reduced by more than 90% since they were first introduced in 1984 [126] This was accomplished, in part, by shifting the

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123 *U S v American Tel And Tel Co* , 552 F. Supp 131 (D D.C , 1982), *aff'd sub nom. Maryland vs U S* , 460 U S 1007 (1983), and *Modification of Final Judgment*, sec VIII B.

124 United States v GTE Corporation, 603 F.Supp 730 (D C Cir 1984)

125. AT&T was authorized to provide intraLATA services in Virginia in 1995 *Investigation of Competition for intraLATA, interexchange telephone service,* Virginia State Corporation Commission, Case No PUC850035, *Opinion*, July 24, 1995.

126 FCC *Trends in Telephone Service, 2002* FCC IATD, released May 22, 2002, Table 1 2

recovery of non-traffic-sensitive ("NTS") costs (principally costs of the subscriber loop) from usage-based per-minute access charges (the so-called "Carrier Common Line Charge" ("CCLC")) to fixed monthly end-user "Subscriber Line Charges" ("SLCs"). While various consumer advocacy groups vociferously resisted the imposition of and subsequent periodic increases in the SLC, consumers responded by sharply increasing their volume of long distance calling, a trend that continued until wireless carriers began offering even better deals — and not only has there been no drop-off in demand for basic local residential exchange service, penetration rates have actually risen, from 91 4% in 1983 to 95.1% today.[127]

109 A BOC's ability to capitalize on its avoided access charges is only relevant while access charges remain in excess of cost When access charges are set equal to the economic cost of terminating traffic, the access costs confronted by the BOC when providing long distance service become much closer to those confronted by competing IXCs, and the importance of the fact that the BOC does not actually make cash payments to itself diminishes. Whether paid for in cash by a nonaffiliated IXC or furnished by the BOC to itself, when access charges are set at TELRIC (or other valid incremental cost standard) the costs that the BOC incurs in producing the service and the costs that the IXC pays in acquiring the service should be quite close.

110 A BOC's *separate* Section 272 affiliate, in its capacity as an interexchange carrier, has exactly the same ability to provide both intraLATA and interLATA services to its customers as

127 *Id* , at Table 17 2

any non-BOC IXC, such as AT&T or WorldCom If in the course of doing so the 272 affiliate is required to obtain intraLATA facilities from the BOC's local service entity (e.g., "one intraLATA arrangement from Dallas to the 272 affiliate's point of presence (POP) [and another] . intraLATA serving arrangement from the 272 affiliate's POP to the Houston location"), *that is no different from what any nonaffiliated IXC would also need to do in order to provide an end-to-end service to a retail customer* Just as AT&T (as an IXC) can offer its customers end-to-end services by combining access services purchased from BOCs with interexchange network facilities owned by AT&T, so too can the SBC or Verizon 272 affiliate (as an IXC) offer its customers end-to-end services *on an entirely equivalent basis* Moreover, just as a non-affiliated IXC is *allowed* to own the facilities interconnecting its customers' premises with its POPs, in which event the IXC can perform full end-to-end testing and provide "seamless" end-to-end services *with respect to those specific circuits*, the BOC 272 affiliate is also "allowed" to own "last mile" facilities, just like any other IXC The fact set under which the BOCs would face a competitive disadvantage *vis a vis* their IXC competitors is one in which non-BOC carriers owned *extensive*, near-ubiquitous collections of "last mile" assets Under any other set of market conditions — and it is that "other" set of conditions that actually prevails here — integrated operation of the local and long distance functions of the BOC would afford the BOCs a level of competitive advantage as formidable and pervasive as that which led to the break-up of the former Bell System

111 Upon sunset of the Section 272 requirements, the BOC IXC business unit, which could then be integrated into the BOC, is in a position to — and undoubtedly will — obtain superior

access to the intraLATA segments relative to what would be available to nonaffiliated IXCs. This is essentially the same situation as has arisen in the case of intraLATA services, where BOCs do not make use of the same "access services and facilities" that are provided to IXCs, thus making the imputation "safeguard" simply not sufficient to protect the IXC from highly discriminatory BOC conduct

112 From many years' experience in dealing with BOC provision of *intraLATA* services in competition with IXCs, we now know that in providing such competitive services (and they have been deemed "competitive" and have been detariffed in a number of states), the BOCs do not themselves utilize the same type of "access services" that are provided to competing (nonaffiliated) IXCs For example, a number of BOC intraLATA toll calls are completed over direct end office-to-end office trunks or through a single tandem; in some cases where multiple exchanges have been consolidated into a single central office switching entity, toll calls among such exchanges will actually be completed on an entirely *intraswitch* basis When an intra-LATA toll call is routed via an IXC, two separate access tandem connections are almost always required, typically involving additional switching and transport *for which the IXC pays* BOCs have regularly argued in state PUC imputation proceedings that they should be permitted to impute the cost of the facilities they actually use, and not the price that they charge IXCs for the facilities that IXCs use

CONCLUSION

113 The survival of competition in the long distance market requires that the BOCs' ability to leverage their entrenched local service monopoly into the adjacent — and presently competitive — long distance be constrained Classification of the BOCs as dominant long distance carriers provides the regulatory mechanism that is needed to implement and to enforce this policy As dominant carriers, BOCs will be compelled to set their prices in compliance with the statutory imputation and nondiscrimination requirements and with the Commission's cost allocation rules, and to justify those rate filings with full documentation and cost support. The extraordinary and unprecedented rate at which BOCs, following their receipt of Section 271 in-region long distance authority, have succeeded in acquiring retail customers — leading to SBC's projection of a 60% end-state market share — raise serious concerns as to the potential for BOC remonopolization of the long distance market Moreover, it is inconceivable, in light of the BOCs' extraordinary success in ramping up their long distance operations, that the BOCs can legitimately claim that dominant carrier treatment would place them at a competitive disadvantage relative to their non-dominant rivals Accordingly, and as long as the BOCs remain fully compliant with the 1996 *Act* and with applicable FCC imputation, tariff filing, and cost allocation rules, the classification of BOCs as dominant long distance carriers will serve only to assure that competition in this sector can be sustained, while imposing no consequential costs or regulatory burdens upon the BOCs

The foregoing statements are true and correct to the best of my knowledge, information and belief

Lee L. Selwyn